State Investment Commission
Minutes
September 26, 2005

The State Investment Commission was called to order by Jonathan Miller, State Treasurer, on Monday, September 26, 2005 in Room 66 of the Capitol Annex at 10:00 a.m. Members present were John Farris, Proxy for Robbie Rudolph, Secretary, Finance and Administration Cabinet; Libby Milligan, proxy for Governor Ernie Fletcher; and Jonathan Miller, State Treasurer.

Treasurer Miller verified that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. Farris and seconded by Ms. Milligan to accept the minutes of the June 10, 2005 meeting. Motion **CARRIED**.

Dwight Price, Portfolio Manager, Office of Financial Management, presented an economic update. He indicated that the Fed Funds rate increased to 3.75 percent, up from 1 percent a year ago. He further stated that it is predicted by the end of December, if the rate continues to increase at the same measured pace, the rate will be 4.25 percent. Mr. Price further indicated that one contributing factor that most likely would have a significant impact on the markets is the expiration of the term of Alan Greenspan, Chairman of the Federal Reserve, in January 2006. Mr. Price stated that purchases of 10-year Treasuries remain high, keeping the interest rate lower than when Fed Funds were at 1 percent. Mr. Price attributed this to the fact that the consumer is not convinced that the economy is booming and that China and Japan are putting the money that Americans pay for imports back into the bond market. Mr. Price continued that the economy appears to be strong even though consumer confidence is not high. Mr. Price felt that is due, in part, to the rising cost of gasoline. Mr. Price stated that the Fed Fund rate will continue to increase mostly likely to the point that the yield curve inverts. Mr. Price stated that if occurs the Fed Fund rate will be higher than ten-year treasuries. He continued that in the past this has resulted in a recession, but he felt that would not happen this time.

Steve Jones, Portfolio Manager, Office of Financial Management, discussed the TRAN. Mr. Jones indicated that the Commonwealth borrowed $500 million in Tax and Revenue Anticipation Notes with an all-in cost of funds of 1.55 percent. Mr. Jones stated the notes were issued in July 2004 with a maturity date of June 28, 2005. Mr. Jones stated that staff entered into an interest rate swap with Citigroup Global Markets, Inc. on which the Commonwealth received 2.23 percent on the fixed side of the transaction and invested the proceeds. Mr. Jones indicated that the earnings on the swap equals the spread between the 1.55 percent cost of funds and the 2.23 percent fixed rate on the swap. Mr. Jones indicated that the TRAN earned approximately $3 million for the Commonwealth in FY05. Mr. Jones indicated that on July 1, 2005, the Commonwealth issued $600 million in Tax and Revenue Anticipation Notes with a maturity of June 28, 2006. Mr. Jones indicated that the Notes had a 2.67 percent cost of funds. Mr. Jones stated that the Commonwealth entered into an interest rate swap against the majority of the $600 million with UBS Financial Services in which the Commonwealth is receiving 3.81 percent. Mr. Jones indicated that the remaining funds were invested in corporate securities and certificates of deposit that match the issue date and maturity dates of the TRAN and is earning 3.82 percent. Mr. Jones indicated that to date the TRAN has resulted in net income to the Commonwealth of approximately $1 million.

Mr. Price stated that one of the advantages of rising interest rates is that the Commonwealth earns a bigger spread on the transaction.

Mr. Jones informed the Commission members that one of the objectives of the investment staff is to determine how much should be invested in the various types of eligible. Mr. Jones informed the members that as of August 31, 2005, the Commonwealth's portfolio included $345 million in Treasury securities and $778 million in Agency securities. Mr. Jones indicated that staff is guided by several factors (target indices, spread, liquidity, and security specific issues) when determining which class to invest in. Mr. Jones stated that the spread between an agency security and a treasury security is one of the most important factors. He stated that spread is determined be several factors including credit risk (there is greater credit risk with the Agency than there is with a Treasury), volatility (spreads will be wider when volatility is higher), general level of rates, shape of the yield curve and specific security issues. Mr. Jones stated that staff has developed a multiple linear regression model to help determine the statistical relationship between Agency and Treasury securities by using the drivers of spread vs. the actual spread. Mr. Jones stated this is an automated process and is available to staff at the beginning of each day. Since May, trades from this model have generated $50,000 in profit for the Commonwealth. He indicated that staff will continue to run the process and trade on a two year and a five year Agency-Treasury model. Mr. Jones continued that staff will be testing the model on two year and five year swaps versus Treasuries and will be seeking approval at the next scheduled meeting to trade swaps based on the model.

Mr. Farris asked if data from the test model was available to show how the trade performed. Mr. Jones indicated that one hypothetical trade based on the model was made during this fiscal year and the net proceeds would have been $2,000 on $10 million. Mr. Price stated the profit was not great but the risk on the trade would be minimal and that staff would not actually execute a trade for $2,000. Mr. Jones indicated that part of the issue is that volatility and spreads have been so tight and not moved that there will not be much opportunity for these types of transactions.

Mr. Price indicated that the Kentucky Bankers Association has recommended Dennis Rich, President and CEO of Eagle Bank in Williamstown, Kentucky to serve on the Commission. Mr. Price stated that this will leave one vacancy and the KBA has indicated they will make an additional recommendation soon.

Mr. Jones reported on the Commonwealth's interest rate straddle position. Mr. Jones indicated the position was unwound on September 23, 2005. He stated that initially the position was executed as a hedge because volatility had declined and staff felt it would turn around and increase. Mr. Jones indicated that if volatility were to increase, the Commonwealth would lose spread on other securities held in the Commonwealth's portfolio. Mr. Jones indicated that volatility has not increased and, in fact, has dropped to a historic low. Mr. Jones stated that since there had been no increase in volatility, staff took the trade off and the Commonwealth suffered a loss of $566,500. Mr. Jones stressed that in spite of the loss, the majority of the Commonwealth's portfolio has performed very well during this time period.

F. Thomas Howard, Acting Executive Director, Office of Financial Management, informed members that this loss would be reflected in the monthly investment report and the total return on versus the indices will still be above the benchmark for the intermediate pool. He continued that the overall strategy is still valid.

With no further business before the Commission, as motion was made by Mr. Farris to adjourn the meeting. Motion **CARRIED**.

F. Thomas Howard, Secretary
State Investment Commission